TEACHERS' RETIREMENT BOARD

REGULAR MEETING

SUBJECT: Cash Balance Plan Update   ITEM NUMBER: 8

ATTACHMENT(S): ___

ACTION: X   DATE OF MEETING: April 2, 1998

INFORMATION: ____   PRESENTER: Ms. DuCray-Morrill

SUMMARY

At its regular meeting on February 5, 1998, the Teachers' Retirement Board approved staff's recommendation to merge the Cash Balance Fund with the Teachers' Retirement Fund to consolidate the administrative expenses of the Cash Balance (CB) and Defined Benefit (DB) plans under a single trust (i.e., a plan merger with two different benefit structures). The Board also requested additional information regarding two related issues. The first issue is whether or not there could be a "windfall" for CB participants if an "overlay" feature were included in the plan merger provisions as proposed by staff. The second issue is whether or not amending the CB provisions to make participation in the plan optional at the employee's discretion would result in state-mandated local costs based on the resulting need for employers to modify their data processing systems to accommodate such a change. Currently the employer controls participation in the CB plan by specifically making or not making the CB plan available to eligible employees. Employees may participate in the CB plan only if the employer enters into a formal agreement with STRS to provide employees with benefits under the CB plan. This agenda item addresses the overlay and optional plan participation issues.

DISCUSSION

Perceived Windfall of "Overlay" Proposal

The overlay proposal would modify the STRS benefit structure to provide Cash Balance participants with a retirement benefit that is the greater of the current CB benefit (i.e., a lump-sum representing the value of their Cash Balance account - which would be the accumulated employee and employer contributions and interest) or a monthly allowance determined under the STRS Defined Benefit formula. Under the overlay proposal, the CB benefit structure would continue to exist as a separate benefit program and participation in the program would continue to be limited to persons who are employed on a part-time basis to perform creditable service for less than 50 percent of the full-time equivalent for the particular position in which they work. Employers and part-time employees who participate in the Cash Balance program would each make CB contributions at the rate of four percent of salary, just as is required under the current plan provisions.

Under the overlay proposal, at the time of retirement (or other distributable "event") a participant is eligible to receive either the CB benefit or a benefit determined pursuant to the retirement formula under the DB program. A CB participant (for instance, a career part-time employee) may reach a point in time where the DB retirement formula would provide a higher benefit amount than the participant would be entitled to receive under the CB benefit structure. To address this possibility, whenever an event occurs (e.g., service retirement), STRS would calculate the participant's benefit under both the DB and the CB benefit structures and would pay the participant the greater of the two benefits.

The cost of providing a benefit based on the DB retirement formula is addressed by collecting contributions at the contribution rate for the current DB plan when a CB participant reaches a crossover point. Reaching the crossover point means the value of the contributions that the participant could receive at retirement as a lump-sum distribution under the CB benefit structure is less than the value of a retirement allowance that the participant could receive under the DB formula based on service credit accrued up to that point. The crossover point is an actuarial determination made on an aggregate, not an individual, basis. That is, the crossover point is a plan design feature and will occur at the same age for every CB participant. The crossover is the point at which the average participant would crossover based on a combination of age and service credit at that time.

An individual will not be determined to have reached the crossover point, regardless of attained age, until the participant accumulates the equivalent of five years of service credit. There are two ways service credit could be determined for a CB participant. The first way would be to use the same method used for that purpose under the DB Plan; that is on the ratio that compensation actually earned by the participant bears to the compensation earnable by the participant on a full-time basis. An alternative method would be to determine the amount of service credit that participant's CB contributions would purchase in the DB Plan and credit service accordingly. It would be preferable to use the same method used in the DB Plan since the purpose for determining service credit is to calculate a benefit under the DB formula.

When the participant reaches the crossover point, the mandatory contribution rate for both the employer and the employee would increase from the four percent each required under the CB benefit structure to eight percent each as currently required under the DB benefit structure. However, the employee would continue to be a CB participant.

All of the employee's eight percent contributions would be credited to the employee's account and would be returned to the employee if a lump-sum distribution were requested in lieu of a benefit under the DB retirement formula. The employer's eight percent contributions would be equally allocated between the employer's account and the Teachers' Retirement Fund (TRF). contributions in the employer account would be returned to the employee if a lump-sum distribution were requested in lieu of a benefit under the DB formula. However, the employer contributions allocated to the TRF would remain in the fund and would be applied to the cost of benefits for CB participants who do receive a benefit under the DB formula. This is similar to the early retirement subsidy in the current STRS DB plan. Under the DB plan, the retirement (age) factor reduction of 0.5 percent between age 55 and age 60 does not recognize the true cost of early retirement. Based on current assumptions, a more cost neutral charge would be 0.67 percent. The cost difference is covered by the TRF.

There may be a perception that the benefit determination process under the overlay proposal could result in a "windfall" to the CB participants who receive a benefit under the DB retirement formula because the rate at which they made contributions was lower for a period of time than the contribution rate would have been if they had been a member of the DB program from the beginning of their employment. However, this perception is unfounded. The term "windfall" implies that someone gets something for nothing, or receives something to which he or she is not entitled. That is not the case with the CB overlay proposal. While paying benefits to CB participants using the DB formula would not necessarily be cost-neutral on an individual basis, the cost on a plan-wide basis would be negligible. It is important to recognize, as stated above, that contributions alone would not cover the entire cost of a benefit paid to a CB participant under the DB formula just as contributions alone do not cover the cost of a benefit paid to a current DB plan member. Investment earnings are also used for this purpose. Another point to consider is that the current CB provisions include statutory authority for STRS to adjust the employer contribution rate when it is determined that increased contributions are required. The adjustment can be up to one-fourth of one percent.

The overlay is a plan design concept and all benefits payable under the plan would be appropriately funded. The fact that some plan participants would receive a retirement benefit determined under the DB formula would not result in benefits to CB participants in general being unfunded or under-funded, regardless of how the benefits are determined. The design of the CB benefit structure would take into consideration the likelihood of a benefit being paid under the DB formula as well as the increase in employer and employee contributions at the crossover point to account for this possibility. These plan design elements would be reflected in the assumptions used to perform the actuarial valuation of the plan.

The concept of providing a benefit that is the greater of two alternatives or that seemingly provides an advantage to certain people is not unique. This concept has always been present in the design of defined benefit plans. An example is the age factor used in the DB retirement formula. This plan feature provides for a member who is age 60 years or older at the time of retirement to receive two percent of final compensation for every year of service. Age 60 is the "normal retirement age" under the DB plan. If a member continues to perform service beyond 60 years of age, the plan realizes an actuarial gain. This gain subsidizes the cost of other benefits which may not be fully funded on an individual basis. Another example is when a member of the DB plan takes a refund of accumulated retirement contributions, STRS retains the employer contributions that were made on behalf of that member and uses the contributions to partially fund the benefits paid to other members of the plan. Just as these plan features do not represent a windfall to DB plan members, neither would the overlay provision be a windfall to CB participants. The same concepts apply to the CB overlay proposal. Contributions collected at the eight percent employer and employee rate will be applied to fund benefits determined under the DB plan formula for participants who perform service after reaching the crossover point.

Some CB participants may make contributions at the eight percent rate after reaching the crossover point, but may terminate employment prior to the actual time when the DB formula would have provided a greater benefit. In this event, the CB benefit would be paid; i.e., a lump-sum distribution of the employee's eight percent contributions and the employer's four percent contributions allocated to the employer's account, plus accumulated interest on both accounts. This ensures that CB participants who receive a lump-sum distribution receive all of their contributions and also the four percent employer contributions made on their behalf just as they would have received prior to reaching the crossover point.

An advantage to including the overlay proposal in the CB benefit structure is that part-time employees would not be forced to choose between the DB and CB programs at a time when it is not possible for them to know on an individual basis which benefit structure would ultimately provide a better benefit. Many employees elect the current DB plan because they intend to pursue a full-time, long-term teaching career only to find several years down the road that their actual situation has taken a different turn and they would have benefited more as a CB participant.

The current approach of requiring a choice between the Cash Balance and Defined Benefit programs at the time of hire has, thus far, not proven effective. A beginning teacher is unable to anticipate at the outset of employment whether the CB or the DB benefit structure would best suit that employee's long-term circumstances. The teacher's ultimate career path may prove to be much different than originally intended. The overlay feature results in a much more equitable approach by providing a retirement benefit based on what actually occurs.

Staff continues to recommend that the Board approve adoption of the overlay concept as a design feature in order to provide a more flexible retirement plan for part-time employees.

Employee Option for Cash Balance Plan Participation

Current statutory provisions specify that an employer may elect to provide the Cash Balance plan benefits for employees. An employee cannot participate in the CB plan unless the employer first elects to provide the CB plan. In a situation where the employee has multiple employers, all of the employers for whom the employee works must make the CB plan available before that employee can participate in the CB plan for service performed with any of the employers. This reality has resulted in administrative difficulty for STRS and creates a disadvantage for some of the part-time employees the plan was established to help. Employee representatives have requested that the CB plan be modified to make participation in the plan optional at the discretion of individual eligible part-time employees.

An advantage to modifying the CB plan to provide for participation at the employee's discretion is that part-time employees would be able to select retirement coverage based on their individual circumstances without employer action required. A person with multiple employers could elect participation in the CB plan for the service performed with each employer.

The proposal to make CB plan participation optional at employee discretion would result in the need for employers to modify their data processing systems to accommodate the employee option. At the same time, many employers are faced with significant computer re-design issues related to the year 2000 compliance requirements. STRS, too, is currently undergoing a major technology change as represented by the departmental START project. In recognition of these efforts, a delayed implementation date of July 1, 2000 for the employee option could alleviate concerns regarding this issue. The delay would provide STRS and employers with time to make the required system changes while still accommodating the employee request for more flexible plan participation parameters.

There has been some concern expressed that removing the employer control on CB plan participation could be deemed a state-mandated local program resulting in employers' eligibility to submit a claim for state reimbursable costs. Although it has previously been determined that retirement benefits do not constitute state-mandated costs, it was not clear if that determination would also apply to benefit-related administrative expenses. STRS' Legal Office contacted the Commission on State Mandates regarding this concern and requested an official answer. The Commission, however, indicated that it would not issue a finding unless a test claim was presented. The Commission did provide STRS' Legal Office with several examples of case law that established legal precedence regarding the issue so STRS could form its own opinion on the matter. From the sources provided, STRS staff counsel determined that removing the employer control on participation in the CB plan would not constitute a state-mandated local program.

Staff recommends that the Board adopt the proposal to modify the CB plan provisions to reflect optional employee participation in the plan.

PROGRAM and ADMINISTRATIVE COSTS

Program Costs

The Cash Balance Plan agenda item presented at the February meeting of the Board (agenda item #8) reflected the actuary's determination that a merger of the DB and CB plans structured with an overlay feature would not have a material increase in the funding period for Defined Benefit Plan. The actuary analyzed the impact of the overlay feature on total plan expenses and determined there would be a marginal increase that would extend the funding period about a half of a year. In actuarial terms, the marginal increase is immaterial and the CB program would still be able to support the minimum interest credit. As indicated in the February agenda item, the negligible actuarial impact is valid even if all part-time teachers in the state are covered by the overlay feature.

Modifying the Cash Balance benefit structure to reflect optional employee participation in the program would not have any associated program cost.

Administrative Costs

The overlay feature would generate some administrative cost, although this would not occur immediately. With a delayed implementation date of July 1, 2000 and the crossover point dependent upon a combination of participant age and service credit, there would not be an impact on the START project. Costs related to the overlay feature would be addressed through the standard budget change proposal process as needed.

Modifying the CB program to include optional employee participation also would result in some administrative cost. This would be addressed through the current implementation effort and should not require additional resources.

RECOMMENDATIONS

The Cash Balance Plan was originally sponsored by the Board because of the Board's long-standing concern with the plight of part-time teachers and their retirement coverage. The CB Plan was intended to provide an adequate retirement benefit to all part-time employees. Current provisions of the CB benefit structure have, in fact, improved retirement security for part-time teachers in general. However, there is room for improvement. Specifically, staff recommends that the Board take the following action:

1. Adopt the proposed overlay concept as a design feature of the Cash Balance benefit structure in order to provide a more flexible retirement plan for part-time employees.

   The Cash Balance Plan was specifically created to address the needs of part-time employees. The overlay feature would ensure that an employee whose career is worked on a part-time basis and who elects to have retirement coverage under the CB program, has the opportunity to receive a retirement benefit appropriate for his or her career employment pattern, even if that means the benefit is determined under the DB retirement formula. The existing approach to retirement coverage forces a part-time employee to choose retirement coverage at the beginning of his or her career even though it is not possible for the employee to know at that time which benefit structure would ultimately provide the better benefit. In this respect, STRS still treats part-time employees as it did before creation of the CB program when part-time employees had to choose between the DB Plan and one of the alternative plans offered by employers.

2. Adopt the proposal to modify the Cash Balance benefit structure to reflect optional employee participation in the program.

   Current Cash Balance provisions require employers to adopt a resolution to make the Cash Balance program available to part-time employees before eligible employees can participate in the program. Thus, in some instances, the very group intended to benefit from the CB program cannot become program participants. This problem is exacerbated for part-time employees who have multiple employers. In this situation, not just one but all employers for whom the individual works must make the Cash Balance program available before the individual can participate. The result is that some part-time employees continue to be denied access to an adequate retirement plan.

   When the employer makes the CB program available, it is usually as a result of the collective bargaining process. This presents a unique situation because, generally speaking, retirement benefits are not bargainable. The current situation would be changed by removal of the requirement for employer action before participation in the CB plan can be elected by an eligible part-time employee. Part-time employees who have been disadvantaged by the current restriction then would be free to fully consider all of the alternatives for retirement coverage.

Adoption of these recommendations would be consistent with the Board's policies to provide a financially sound plan with adequate benefits for the retirement of teachers. In addition, adoption of the employee option would simplify STRS administrative effort by implementing more efficient administrative practices. Any additional cost that may result from adoption of these recommendations is outweighed by consideration of the policy issues.